VZCZCXYZ0000
RR RUEHWEB

DE RUEHEG #2868/01 2661509
ZNR UUUUU ZZH
R 231509Z SEP 07
FM AMEMBASSY CAIRO
TO RUEHC/SECSTATE WASHDC 6990
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC 0343

UNCLAS CAIRO 002868

SIPDIS

SENSITIVE
SIPDIS

STATE FOR NEA/ELA, NEA/RA
USAID FOR ANE/MEA MCCLOUD AND DUNN
USTR FOR SAUMS
TREASURY FOR MATHIASON AND HIRSON
COMMERCE FOR 4520/ITA/ANESA/OBERG

E.O. 12958: N/A
TAGS: ECON EAID EFIN EINV EG
SUBJECT: IMF BULLISH ON EGYPT: ARTICLE IV CONSULTATION REPORT
PRAISES MACROECONOMIC PERFORMANCE

Sensitive but Unclassified. Please protect accordingly.

Summary

¶1. (SBU) The IMF recently concluded its annual Article IV visit to Egypt, issuing a preliminary report lauding the success of Egypt's macroeconomic reform. The report cited strong economic growth and a decline in unemployment as signs of the program's success. Inflation is a concern, but the spike in early 2007 was due to one-off events, not underlying inflationary pressure. More reform is needed to attract more investment, if Egypt's economy is to grow at a rate sufficient to sustain job creation. The deficit must also be reduced, and the GOE has an ambitious plan to reach a deficit of 3% by FY10/11. Cyrus Sassanpour, IMF Resident Representative, agreed with the Treasury Attache that the report was quite positive, and noted that the GOE could reach its deficit reduction target simply by consistently cutting fuel subsidies. Sassanpour recognized the need for continued reform, and believes now is the time - when the economy is performing well - to enact those reforms. While the report accurately reflects improved macroeconomic figures, it does not mention some of major problems still facing Egypt's economy, including corruption.

Strong Macroeconomic Performance

¶2. (U) The IMF's preliminary Article IV report, issued September 12, lauded Egypt's macroeconomic reform, highlighting estimated real GDP growth of 7.1% in FY06/07 (July 2006 - June 2007) and a decline in unemployment from 10.5 to 9% as evidence of the program's success. Strong growth was supported by record FDI inflows, (the GOE estimates FDI will reach $6 billion in FY06/07), which also fueled inflation as domestic demand increased. Peaking at 12.8% in March 2007, inflation has since decreased to 8%. The IMF report echoed official GOE assertions that the spike in inflation was caused by an avian flu outbreak and fuel subsidy reductions, and is therefore not a long-term concern. The report predicts inflation will average 6-8% for the next few years - consistent with an economy growing at 6-7% annually, with annual FDI in the range of $6 billion - provided money growth does not increase more than 15%.

¶3. (U) The fiscal deficit declined from around 9% in recent years to 7.5% in FY06/07, due to structural reform of the tax system, subsidy reductions, a Treasury Single Account, and windfall profits from issuance of a third mobile phone license. Privatization

proceeds also increased revenues, and spurred private sector growth. The July 2007 issuance of Egypt's first international local currency bond will help establish a benchmark interest rate and aid in domestic capital market development, according to the report (Note: The bond has an unusual design: Denominated in dollars, proceeds from the issuance were given to CBE to convert into Pounds at the existing exchange rate. At interest payment times and at maturity, the Ministry of Finance will calculate and pay interest to CBE in Pounds, which will convert the Pounds back into dollars at the existing exchange rate before pay out to investors. Under this design, investors take the exchange rate risk, not CBE).

More Investment Needed

¶4. (U) The IMF noted that to sustain growth and job creation, investment equal to 26% of GDP is needed over the next few years. Obstacles to this level of investment include poor infrastructure and government services, lack of credit to SMEs, and lack of trained labor. Further structural reforms are also needed to meet the GOE's deficit target of 3% by FY10/11. While expressing confidence in the GOE's ability to meet this target, the report notes that deficit reduction is the overarching challenge for the GOE (Note: Several of the IMF recommendations for reducing the deficit, including property and sales tax reform and improved cash management, are benchmarks under the "Private Sector Development" portion of the proposed new USAID cash transfer program). The IMF also recommends that fuel subsidies - currently 5-6% of GDP - be further reduced. Such reduction would discourage investment in energy-intensive industries in which Egypt does not have a long-term comparative advantage, according to the report.

¶5. (U) While noting the potential for "reform fatigue" as some are adversely affected and/or disappointed with reform, the IMF encourages Egypt to take advantage of the favorable outlook to continue with reform. The report was broadly supportive of CBE's movement toward an inflation-targeting monetary policy, and encouraged more privatization in the banking sector, which is already approximately one half private sector-owned resulting from a financial sector reform program. The full Article IV report is expected to be considered by the IMF Board in November.

IMF Representative Bullish

¶6. (SBU) Cyrus Sassanpour, IMF Resident Representative (ResRep) echoed the report's laudatory assessment to TreasAtt. While praising the solid macroeconomic numbers, he recognized that the GOE data, upon which the report is based, is not always reliable. Local analysts, including Sassanpour, believe that the GOE consistently underestimates unemployment. Sassanpour was especially critical of the Central Agency for Public Mobilization and Statistics (CAPMAS), the main data gathering agency, though their information has improved somewhat in recent months. Budget transparency has improved, according to Sassanpour, largely due to the Minister of Finance's efforts to increase transparency in GOE agencies. Despite improved budget transparency, and improvement in the way fuel subsidies are shown in the budget, the Article IV report cited transparency in the Egyptian General Petroleum Company as an area still in need of improvement (Comment: Improved budget transparency is one means of empowering civil society to demand greater government accountability. We are hopeful that increased USG and donor attention to this issue will have some democracy dividends).

¶7. (SBU) Sassanpour also noted that the dividends of macro reform are being felt, as investors now see Egypt as a stable investment destination, a view backed by the growing FDI figures. He argued that the GOE can meet its target of reducing the fiscal deficit by 1% of GDP annually simply by consistently cutting subsidies. The GOE has put forth a plan to reduce energy subsidies to industry over the next five years, and Sassanpour expects another cut before the end of the year. On the revenue side, better enforcement of the new tax law is needed, but the new law itself, coupled with restructuring of the Tax Authority, is a major achievement. Within

the MENA region, Sassanpour argued that Egypt is now a tax reform leader, a view expressed by other MENA countries at the last OECD-MENA Investment Conference.

¶8. (SBU) While the macro picture continues to be fairly rosy, Sassanpour noted that more reform is still needed in the real economy, particularly in agriculture, infrastructure, labor markets, and skills training. These reforms need to happen while the economy is doing well, so the difficult adjustments required by such reforms can be offset by overall growth and job creation.

Comment

¶9. (SBU) While the IMF report accurately reflects the improved macroeconomic environment in Egypt, the macroeconomic picture is only part of the overall economic landscape. The Minister of Finance, with whom the IMF works closely, has made monumental efforts to improve Egypt's fiscal situation. His efforts, however, and those of economic reformers in general, continue to face political obstacles and sectoral challenges. Corruption remains a major impediment to growth. The culture of cronyism and family connections is still deeply rooted in Egyptian society, and affects the business sector from start up through operation and expansion. Business owners still need the right "connections" to facilitate access to land and utilities, issuance of licenses, financing, and contracts. The World Bank, which works more closely with the financial sector than does the IMF, has a decidedly more skeptical view of the likelihood of continued economic reform (septel).

JONES